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RUEHDBU/AMEMBASSY DUSHANBE 0132
RUEHNE/AMEMBASSY NEW DELHI 0795
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DEPT FOR SCA/CEN, AND EB/IFD/OIA
DEPT PASS TO USTR

E.O. 12958: N/A
TAGS: ECON EFIN EINV ELAB ETRD KTDB PGOV OPIC USTR UZ
SUBJECT: Part 1 of 2, 2008 Investment Climate Statement for Uzbekistan

REF: 07 STATE 158802

Openness to Foreign Investment

¶1. With an estimated population of 27.3 million, Uzbekistan has the largest population in Central Asia. Rich natural resources such as gold, gas, and cotton offer potentially attractive opportunities for investors. Uzbekistan is the world's fourth largest cotton producer and second largest cotton exporter after the United States. Uzbekistan has the potential to be a regional economic powerhouse, but the government of Uzbekistan ("the government") has yet to create the necessary conditions to attract needed foreign investment. Currency convertibility is cited by foreign firms as the single greatest obstacle to normal investment operations.

¶2. The declared policy of the government is to attract foreign investment. Existing legislation on its face grants foreign direct investors a host of incentives on a case-by-case basis, including tax holidays, duty-free import of capital goods, and protection against expropriation. However, the requirements for obtaining these benefits are ambiguous, the processes and procedures are cumbersome, and the regulatory environment is capricious. While such conditions provide opportunities for some companies to turn special decrees and privileges to their advantage, the lack of predictability deters many potential investors.

¶3. According to Uzbek law, the state must guarantee and protect the rights of foreign investors within the country. Primary legislation that guarantees foreign investment includes the following decrees: "On Foreign Investments," "On Guarantees and Measures of Protection of Foreign Investor's Rights," "On Guarantees of the Freedoms of Entrepreneurial Activity," and "On Production Sharing Agreements."

¶4. Enterprises with foreign investments enjoy tax concessions and preferences, such as a reduced profit tax rate, grace periods, and exemption from customs duties on the property imported by foreign investors for their own production and personal needs. However, the

government has in some cases negated this benefit by reclassifying foreign investments as joint ventures or local investments. Foreign investors also are shielded for ten years from legislative changes that adversely affect existing investments. In July 2006, however, the government rescinded all existing, indefinite tax breaks for foreign companies, other than those with product-sharing agreements, such as oil and gas companies. This adversely affected a number of foreign businesses, mostly American and European, and some closed operations. The 2006 legislation, which was retroactive, did not allow investors to claim damages.

¶5. In principle, the judicial system upholds the sanctity of contracts. However, the judiciary is not independent and has favored state-owned or government-affiliated entities in commercial disputes. Foreign investors often retain independent local counsel.

¶6. The government plans to retain controlling shares of some key industries, including oil and gas, aviation and mining. The government limits access to the raw cotton market, thereby exercising effective control of investments and capital flows. The government controls all silk sold in the country, and this dampens foreign investment in the textile and rug-weaving industries. This is not an exhaustive list. The government's role in key industries can have discriminatory effects on foreign investors. The government has announced plans to privatize some mid-sized and large state-owned companies but has not yet done so. Moreover, a variety of challenges exists, including unrealistic valuations and the choice of which assets to retain.

¶7. In the banking and insurance sectors, foreign ownership is restricted. In banking, foreign investors are prohibited from legally operating except as joint venture partners with Uzbek firms,

and foreign ownership of banks is limited to 50 percent. Banking and insurance firms with foreign participation are required to establish a charter capitalization fund of 5 million Euros, whereas the government determines the required size of the charter funds for Uzbek firms on a case-by-case basis. (See also paragraph 17).

¶8. An "enterprise with foreign investment" and an "enterprise with foreign capital" are treated differently in Uzbekistan. Foreign investors act as shareholders in both cases; however, an enterprise with foreign investment has a special status and additional requirements, including:

-- foreign investments must comprise at least 30 percent of shares of the charter fund of the enterprise;

-- foreign investors, as a legal entity, must be among the participants in the enterprise; and

-- the minimum amount of charter capital must not be less than USD 150,000 (for enterprises established within the Republic of Karakalpakistan and Khorezm province, the amount is USD 75,000).

¶9. Enterprises that meet the above requirements can be registered as "enterprises with foreign investment." Enterprises that do not meet the above requirements are subject to state registration at the offices of regional governors (hokimiyats) as ordinary enterprises.

¶10. If the charter fund of an enterprise with foreign investment comprises USD 20 million or more, a special government resolution is needed to register the enterprise. Frequently even smaller investments require permission from government authorities. The Uzbek government requires screening of foreign investment in sectors of the economy that it determines are strategic, including mining, cotton processing, oil and gas refining, and transportation. The government does not have a standard and transparent screening mechanism, and the legislation is designed to protect domestic industries and limit competition from abroad. In some instances, screening has been used by the government to limit investment in certain industries and by certain countries.

¶11. The following sectors are relatively more open to foreign direct investment (FDI): oil & gas exploration, extraction and processing; power (transportation and distribution, renewable energy); machine building (automotive, agricultural, railroad trains and cars,

aerospace, etc.); and tourism infrastructure. However, the government closely scrutinizes investments, particularly those deemed to involve strategic national interests.

¶12. According to legislation, foreign investors and investments receive treatment equal to that afforded local investors.

¶13. Uzbekistan subscribes in principle to policies of institutional and economic reform, such as restructuring and privatization, in order to attract more foreign investment. However, implementation has been limited. A 2007 decree on privatization is promising, but implementation has not begun. The government to date has been unwilling to sell controlling interests in enterprises, and often has demanded prices far in excess of what investors would be willing to pay. Enterprises developed under the previous Soviet economic system need significant restructuring before they can be successfully privatized. In general, the tender process for privatization is transparent only at the initial stage. The government attracts international financial consultants for privatization of large enterprises. Only after the evaluation of an enterprise is completed are foreign investors invited to participate in the process. Many investors note a significant lack of transparency at the final stage of the bidding process, when the government begins conducting direct negotiations with the bidders before announcing the results of the tender. In some cases, the government lobbies foreign mailbox companies associated with influential Uzbek families. While these companies have a foreign address, their ties to the foreign country are tenuous.

¶14. There is no official discrimination policy against foreign investors at the time of the initial investment or after the investment is made. Certain incentives designated by presidential decree are granted on a case-by-case basis and are often disputed during the investment period. This issue is particularly acute in regards to tax incentives and registration requirements. Recently, several foreign investors noted conflicts between new legislation and a Presidential Decree on tax holiday time limits. Presidential decrees are in practice easily overturned, and foreign companies have recently been detrimentally affected by the practice.

¶15. Foreign and local investors both suffer from government interference in investments, and bureaucratic obstacles consume significant time and resources. The current system of taxation is complicated and ambiguous. The taxation legislation makes offset of current losses impossible: a company that does not show a concrete profit for six months is considered bankrupt. The legislation also sets strict limits on deductions for marketing, communication and training expenses, and thus greatly inflates taxable income when compared with legislation in other countries. Corruption and rent seeking are endemic. A new Tax Code has been approved and entered into force January 1, 2008. Despite some decrease in tax rates and the allowance of deductions for certain expenses, the new code does not significantly alter the existing situation and does not address the issue of official corruption.

¶16. Foreign investment, participation, or control in private firms in the media sector is prohibited. According to the "Law on Mass Media" adopted on December 26, 1997, and updated in 2005, only Uzbek nationals can own a mass media enterprise. Joint ventures cannot apply for a mass media license or own/establish a mass media enterprise if the shares of the foreign investors exceed 30 percent.

¶17. Foreign ownership of private firms is in principle unrestricted, with the significant exception of firms in the media, tourism, banking and insurance sectors (see paragraphs 7, 16 and 32). However, the government often exerts influence over the operations of companies, even those where foreign investors own over 50 percent. In many privatized enterprises, the government retains a minority share of approximately 25 percent, and workers own another 25 percent, thus limiting effective control by outside investors.

¶18. Uzbekistan has all the ingredients needed to become a regional economic powerhouse: a dynamic, literate, and entrepreneurial population; a central location at the crossroads of Central Asia; relatively good infrastructure; rich mineral resources; and a large potential consumer market. The lack of macroeconomic and structural reforms has exacerbated bureaucratic inefficiencies and contributed

to widespread corruption. Businesses and investors suffer from a multitude of problems caused by government policies. Instead of instituting structural reforms immediately after independence in 1991 and weathering the resulting economic hardships, as some other post-Soviet countries did, the government chose to avoid taking painful reform measures and now faces a rapidly declining planned economy. Official statistics expect GDP growth rate to be 9.8% in ¶2007. This growth is mostly due to the natural gas and construction sectors, as well as remittances from large number of Uzbeks working abroad. The construction sector is contracting, as Kazakh investors in Uzbekistan react to the credit crunch in their own country. Currency restrictions through the banking system hamper business and economic development, as do the government's restrictive trade policies. The government's manipulation and interference in the private sector leave companies unable to properly project profits and future capital purchases.

Conversion and Transfer Policies

¶19. Uzbekistan introduced currency convertibility in October 2003, but in practice access to foreign currency is limited. Two legal exchange rates exist: the commercial (wire-transfer) rate and the exchange booth rate. All citizens have legal access to the exchange booth rate. Limitations to foreign exchange resulted in 2007 in average lag times of four months for current account convertibility for imports and slightly less for raw materials related to manufacturing. As of December 2007, the black market rate of 1,340 soum per U.S. dollar exceeded the official exchange booth rate of 1,288 by roughly four percent. Although the government has committed to the provisions of the International Monetary Fund's Article VIII regarding currency convertibility for current account operations, in practice multiple informal restrictions remain in place. All legal entities must obtain permission from the Central Bank to access foreign currency, and applicants must expend significant time to navigate the bureaucracy. The government reportedly issues banks confidential instructions detailing which orders are to be filled.

¶20. The majority of foreign investors, regardless of nationality, report frequent difficulty obtaining sufficient foreign currency for operational requirements. Investors also experience delays of one to six months when remitting profits, and during the interim the amount to be remitted is held by the Central Bank. These delays are at least in part a result of the government's tight fiscal and monetary policies - the government runs a strict import subsidies regime to control foreign trade and prevent capital outflow. However, the policy also presents the potential of co-mingling or misuse of investor funds.

¶21. No legal, private, parallel market exists in Uzbekistan for investors to remit funds. However, private money transfer businesses are numerous and have few problems receiving foreign remittances. The government has phased out its previous system of import contract registration and replaced it with a regime of high tariffs and border closings in order to further promote a policy of import substitution. Due to border closings, foreign investors often experience delays in receiving necessary production inputs.

Expropriation and Compensation

¶22. The government may seize foreign investor assets for violation of local legislation, breach of contract, failure to complete, as well as for arbitrary reasons such as reevaluation of assets, site or development programs, etc. Although the government can legally seize property with compensation at fair market value, it has expropriated property of joint ventures (with foreign investment partners) at lower than fair market value. The government has also inadequately compensated local businesses and individuals for seized property. Agricultural enterprises are particularly vulnerable to expropriation of land.

¶23. Recent changes in tax legislation, especially regarding tax holidays, have caused financial difficulties for existing foreign

investors. Though this has not been construed as an attempt to expropriate investor holdings, it is a matter of concern.

¶24. Large, lucrative foreign businesses are more at risk for expropriation or similar action than others. In 2006, the government targeted the two largest U.S. joint-ventures and attempted to push them out of the country and expropriate their assets. These two cases were eventually resolved, one through a negotiated settlement and the other through arbitration. In both cases, the U.S. partners relinquished their shares and left Uzbekistan. The U.S. Embassy is aware of expropriation cases involving non-U.S. companies, in the trading sector, food processing, furniture manufacturing, and gaming businesses.

Dispute Settlement

¶25. Uzbekistan does not have a uniform, well-defined method of settling disputes or a legal system that fairly and effectively

enforces property and contractual rights. Government officials inconsistently interpret laws and presidential decrees, which often conflict with each other. Government interference in the court system is common, as are accusations of corruption.

¶26. Investors have no reasonable expectation that the government will honor an international arbitration verdict in favor of the foreign plaintiff. Contractual provisions for international arbitration are insufficient. If international arbitration is permitted, the awards can be challenged in domestic courts. The Ministry of Justice is responsible for the resolution of all international commercial issues. Its power is limited and frequently co-opted by more influential powers within the government. A number of foreign companies have not received full payment, even after being awarded a judgment in international arbitration. Others have pursued a claim and won in the court system, only to have the government not enforce the ruling. There are several cases, however, in which international arbitration awards have been successfully enforced.

¶27. Most disputes involve nonpayment or delayed payment for goods or services by state entities. The State Tax Committee may sequester funds from a company account before the court reviews the arguments of the company in the dispute. The greatest number of U.S. investor dispute cases have occurred in the following sectors: trading, food processing, manufacturing, telecommunications, defense, energy, gaming, and tourism. The only non-payment pattern the U.S. Embassy has noted is in delivering products to the agro-chemical sector. Disputes with joint venture partners, whether state-owned or private, are also common. These disputes reflect a pattern of U.S. investors relying too heavily on local partners and not thoroughly vetting them before developing the joint venture partnership. The local partners frequently cannot stand up to heavy government pressure or are simply corrupt.

¶28. Uzbekistan is a member of the International Center for the Settlement of Investment Disputes and a signatory to the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (The "New York" Convention). However, numerous companies have reported that the local courts, including the Tashkent Economic Court and the Supreme Court, have failed to enforce international judgments against Uzbek companies, particularly state-owned enterprises.

Performance Requirements/Incentives

¶29. Uzbekistan has not yet notified the WTO on inconsistencies with Trade-Related Investment Measures (TRIMS) requirements. However, in reply to WTO questions and at the request of a WTO member, Uzbekistan described its "localization" program, a provision of Resolution No. 18 of the Cabinet of Ministers issued 14 January 2004, that provides "Exemption from profit tax, single tax (for entities subject to the simplified system of taxation) for a percentage of products manufactured under localization projects". Certain provisions of Resolution No. 18 violate the WTO TRIMS

agreement, namely that local businesses must use products of domestic origin in manufacturing to receive advantages under the localization program. This allegedly violates the WTO TRIM Annex 1(a).

¶30. According to Uzbek legislation, requirements to use domestic products in manufacturing are to be applied uniformly. In practice, this is not always the case. For example, the government has granted some companies the advantages and incentives afforded under the localization program, even though they do not use local materials in production or assembly.

¶31. Customs payment exemptions envisaged under Resolution No. 18 are not in conflict with Paragraphs 1 and 2 of Article III of GATT, because this incentive is afforded to imported goods not produced in Uzbekistan. Thus, there is no official import discrimination. In

certain situations conditions are actually more favorable for foreign investors, as is the case with the services sector specifically relating to freight forwarders: foreign freight forwarders are exempt from VAT, while local companies are not.

¶32. While there are no set pre-conditions for investing, companies must invest USD 150,000 in charter capital to qualify for certain incentives. In addition, a foreign investor must invest at least 30 percent in a business for the company to be legally considered a company with foreign investments. Also, as noted above, companies must purchase products from local sources to qualify for the localization program. This requirement applies to both foreign and local investors; therefore, there is no national treatment problem under Article III GATT '94. While there are no requirements that foreign equity be reduced over time, certain restrictions regulate foreign investments in the banking sector, where the foreign share cannot exceed 50 percent, and in the tourism sector, where it cannot exceed 49 percent.

¶33. Any sector that is not a priority industry for the Uzbek government should expect to have more difficulty importing capital and consumer products than a priority industry. Requirements affecting these industries are likely considered restricted information by the government and not applied uniformly.

¶34. Permission is not officially required to invest, though preference is unofficially given to non-western firms and those that are closest to the decision-makers. There are incentives to attract foreign investments to less developed locations (mostly rural), but there are no requirements. In the banking sector, branches are not recognized as legal entities and therefore cannot provide banking services that utilize the capital of the parent company. Substitution for imports is covered under a localization program, discussed in paragraphs 29 and 30. Host country employees are required in some positions in banking and auditing companies: the chief accountant should be an Uzbek national, as should either the CEO or one member of the Board of Directors. In the tourism sector, only Uzbek nationals can be tour guides. There are no requirements for using only local sources of financing.

¶35. The government intends to eliminate requirements that are in violation of certain WTO agreement provisions (such as TRIMS, the Agreement on Subsidies and Countervailing Measures, and the General Agreement on Tariffs and Trade) by the time Uzbekistan accedes to the WTO. In October 2005, the government presented its offer on goods and services to a WTO working group in Geneva. There are no regulatory requirements for foreign investors to disclose proprietary information. General legislation, such as the Civil Code (Chapter 64) and "Law on Monopolistic Activity" (Article 8), provide for general principles for the protection of commercial and trade secrets. Participation in R&D is not regulated legislatively; therefore, there are no government restrictions.

¶36. Uzbekistan offers two types of non-tourist visas: a temporary business representative visa and a working visa. To apply, American citizens must submit documents regarding the company/ business they are affiliated with to an Uzbek Embassy or Consulate. Currently almost all applicants experience delays or other problems in obtaining Uzbek visas. Many non-resident, private American citizens continued to receive visas limited to one month. Foreigners working in Uzbekistan must register with the Ministry of Labor.

¶37. There are non-tariff barriers, such as discriminatory excise tax rates for certain imported goods. Some goods are banned for export, including grain and sugar. Import of ethyl spirit is prohibited.

Right to Private Ownership and Establishment

¶38. Uzbekistan's laws and decrees guarantee the right of foreign and domestic private entities to establish and own business enterprises and to engage in most forms of remunerative activity. The state

reserves for itself the export of gold. Cotton and gold exports generate most of Uzbekistan's foreign exchange earnings. The government announced in a 2002 decree that it planned to scale back its monopoly of the cotton export trade and allow producers to sell 50 percent directly to buyers. To date, however, this change has not occurred. Foreign companies have entered the cotton and gold production sectors, specifically grading, treatment, and marketing of cottonseed, and mining and refining of gold. Some U.S. companies have reported experiencing problems in the cottonseed and gold refining businesses.

¶39. Theoretically, private enterprises may freely establish, acquire, and dispose of equity interests in business enterprises. In practice, however, it can be difficult to do this, as securities markets are undeveloped.

¶40. Businesses face more than the usual amount of bureaucratic hurdles if they compete with the government or a government-controlled firm in certain sectors, such as minerals.

Protection of Property Rights

¶41. Uzbekistan's laws governing the acquisition and disposition of property pose relatively few problems for foreign investors, and are similar to laws in other CIS countries. Foreign entities may own buildings, but not land. The concept of property ownership exists and is respected by local and central authorities, as long as the government is not interested in owning that property. If the government or a well-connected entity decides it wants to own a piece of property, the original owner of the seized property should not expect to receive remuneration at market value. Each district Hokimiyat has a department responsible for management of commercial real estate and controls all activities relating to the sale and purchase of commercial real estate, from paperwork to asset valuations.

¶42. Uzbekistan has actively voiced its interest in joining the WTO but is only in the early stages of implementation of the appropriate agreements, including TRIPS. In 2004, Uzbekistan submitted documentation to become a party to the Berne Convention. In 2006, the Uzbek Parliament adopted all but one component of the Berne Convention: Article 18, regarding protecting pre-existing works. This year the government amended its Civil Code to match the IPR laws previously adopted. Presently, Uzbekistan is a consumer, but not a significant producer, of pirated material. On the streets, pirated audio and videotapes and compact disks are sold freely.

Transparency of the Regulatory System

¶43. Ambiguous rules, legislation, and presidential decrees on foreign investor rights are often contradictory. On many occasions, local officials have interpreted laws in a manner that is detrimental to individual private investors and the business community at large. U.S. companies have complained that Uzbek laws are not interpreted or applied consistently. In addition, the government occasionally issues secret decrees or instructions that entities are required to comply with, despite having no knowledge of the order. Companies are particularly concerned with the consistent and fair application of the "Law on Foreign Investment," which outlines specific protections for foreign investors. Because of the prohibitive tax code and regulatory environment, foreign investors

often seek tax incentives and relief from certain regulatory requirements through Cabinet of Ministers decrees, which are approved directly by the President. These, however, are easily revocable.

¶44. The new Tax Code (see paragraph 15), like the old code, lacks important provisions found in most developed countries. For example, it does not allow credit for VAT on capital imports,

including plant, machinery, and buildings. This puts firms operating in Uzbekistan at a competitive disadvantage. The tax code makes no provisions on double taxation, and earnings of foreign-owned enterprises are therefore susceptible to double taxation. A double taxation treaty negotiated with the U.S. in 1994 has been ratified by Uzbekistan but not by the U.S. The law on labor unions says that labor union fees are voluntary, but in practice commercial courts interpret these payments as compulsory and impose penalties on non-payers. The amount of money involved is not large, but the issue may be of concern to foreign companies with union policies and concerns. Strict rules on wages severely discriminate against foreign companies who follow the rules, whereas local firms often evade the laws by creating false employees.

¶45. Bureaucratic procedures, in particular financial reporting, are considered time-consuming and counterproductive. Government-owned banks, ministries, and agencies interfere in business operations and in some cases make efficient operations almost impossible. Documents required for licensing, registration and other permits are often amended without notice, which creates an opportunity for rent-seeking. As a result, documents are frequently rejected the first time they are submitted on the grounds of some technicality.

¶46. The government holds a monopoly on regulatory processes. However, influential actors in the "shadow economy" can create problems for foreign investors in certain sectors, such as telecommunications, real estate, mining, etc., by encouraging authorities to pressure foreign competitors.

¶47. Publishing drafts of laws and regulations for public comment is uncommon in Uzbekistan. Regulatory bodies often introduce changes and amendments to the commercial legislation without notification, which causes many disputes and misunderstandings, even among state institutions. In a few cases where legislation will be highly scrutinized by the private sector, certain well-placed foreign investors have had the opportunity to review and comment on upcoming legislation. However, these instances are extremely rare. There is often a considerable delay between the passing of a law and its full release for public consumption. The government has been discussing the creation of a foreign investor council, which would provide an excellent opportunity to review draft laws on commercial issues. The Uzbekistan Chamber of Commerce and Industry has taken the lead in organizing discussions for investors and business people on issues of particular note as part of a larger forum.

¶48. Few of the local legal, regulatory, and accounting systems are transparent and consistent with international norms. For instance, local accounting standards and practice in some respects contradict internationally accepted standards. Although international advisors are working to develop the sector and train accountants, local practice is still document and tax driven with an underdeveloped concept of accruals. As a result, financial reporting seldom accurately represents the financial position of Uzbek companies with foreign investments.
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